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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

No. 1138

RICHARD H. DUNNING and BEULAH MARIE DUNNING,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITIONERS' REPLY BRIEF

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Respondent argues (1) that the issuance of warrants in exchange for the old common stock was of no significance and that the reorganization should be treated simply as if the common stock had been eliminated, and (2) that to permit the deficit to carry through the reorganization would produce a tax benefit akin to a double deduction. These arguments, closely inter-related, are both erroneous.

The warrants were of great economic benefit, significance and value to Middle West. The original Plan of Reorganization called for the issuance of only 2,399 warrants (R. 87). Objections sustained by the Court were made to this phase of the Plan as the result of which the Plan was modified to require the issuance of 13,000 warrants (R. 89). This was the only modification of the original Plan and its significance in terms of continuing control of the corporation is apparent when related to the fact that Middle West

received 30% of the new common stock and was by far the largest single shareholder.

Respondent errs in stating (Br. 5) that warrants do not constitute "stock or securities" subject to the non-recognition provisions of §112. *Helvering* v. *Southwest*,[1] cited by respondent, does not so hold, but holds merely that warrants are not the equivalent of "voting stock" within the meaning of clause (C) of § 112 (g) (1), a provision not involved in this case. Warrants have been consistently held to be securities.[2] Respondent cites no contrary authority.

The very fact of the issuance of the warrants is one factor requiring the transaction to be treated as an exchange rather than as an "elimination" of the common stock. There was an exchange of (common) stock for securities (warrants). More accurately, there was an exchange by one taxpayer of 75% of the old voting stock (common and voting preferred) plus promissory notes[3] for 30% of the new voting stock plus warrants. What was received was solely stock or securities and the loss (if any) upon the exchange was not permitted to be recognized under §§ 112 (b) (3) and 112 (b) (4) of the 1936 Revenue Act.

Although Middle West may have received new common stock "qua" its interest as creditor rather than "qua" its interest as a shareholder, that fact is irrelevant. Every Court of Appeals which has considered a similar question has so held.[4] Respondent concedes (Br. 7) the existence of

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1. 315 U.S. 194, 62 S. Ct. 546, 86 L. Ed. 789 (1942).

2. *E. P. Raymond* v. *Commissioner*, 37 B.T.A. 423 (1938); G.C.M. 2177; VI-2 Cum. Bull. 3501 (1927); and see *William H. Bateman* v. *Commissioner*, 40 T.C. 408 (1963).

3. Referred to by respondent as bonds, Br. 2, 5.

4. *Commissioner* v. *Huntzinger*, 137 F. 2d 128 (10th Cir. 1943); *Prairie du Chien-Marquette Bridge Co.* v. *Commissioner*, 142 F. 2d 624 (3rd Cir. 1943); *Seiberling Rubber Co.* v. *Commissioner*, 169 F. 2d 595 (6th Cir. 1948); and see *United States* v. *El Pomar Inv. Company*, 330 F. 2d 872 (10th Cir. 1964).

a conflict between Circuits if *El Pomar* stands for the proposition that the continuity test is satisfied and the deficit carries over where a stockholder who is also a creditor participates in the reorganization "qua" creditor but not "qua" stockholder. *El Pomar* stands for precisely that proposition.

For the first time respondent here contends that the reorganization produced a worthless stock deduction. Neither court below so held. In none of the cases relied upon by respondent was there reliance upon a worthless stock deduction theory. If the stock had been worthless no one would have bothered with an exchange. When the exchange occurred, Middle West (the only taxpayer who could conceivably claim any such deduction) was required to allocate its adjusted basis in the old common stock and promissory notes to the property received upon the exchange. Only upon the disposition of that property would gain or loss be recognized by Middle West.

Petitioners believe that the "double deduction" argument is erroneous. More important for present purposes, however, is the fact that if respondent's argument is accepted as legally sound, the conflict between the Circuits becomes even more apparent, because acceptance of that argument on the merits means that *Snider*[5] and *El Pomar*[6] (which petitioners believe are controlling) were incorrectly decided.

The petition should be granted.

Respectfully submitted,

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5. 224 F. 2d 165 (1st Cir. 1955).
6. *Supra*, footnote 4.